Comments

At the outset I would like to say that Iqbal. Zaidi (IZ) has given a very comprehensive exposition of the issues related to the exchange rate regime, choice of a nominal anchor in monetary policy framework and inflation targeting. I think one of the major contributions of his paper is the stimulus given to the debate on inflation targeting regime in Pakistan. My comments on his paper are just a reinforcement of his ideas and in no way challenge his thoughts.

Regarding the 'intermediate exchange rate regime' I think there are a few points which need attention: The bipolar view, which emerged from Robert Mundell's 'impossible trinity', as mentioned by IZ, has been debated a lot in literature, but we should still not ignore these views altogether. According to the bipolar view the intermediate policy regimes are not sustainable and as a result of the different financial crises during the 1990s countries have moved away from 'soft pegs' to either ends of the exchange rate spectrum. This phenomenon is termed as the 'hollowing out' or the 'hollowing middle' in literature. Fischer, the former Deputy Managing Director of IMF, and several other authors, have pointed out to this fact. Fischer observes that this tendency is not among those countries only, which are active in international capital markets, but can be found in other countries as well. Fischer (2001) has suggested that this trend would continue among all emerging countries with open capital markets since soft-pegs are crisis-prone and not viable for long periods due to the logic of 'impossible trinity'.[1] Another influential view by Eichengreen et al. (1999) conclude that pegged exchange rates are crisis prone for emerging markets and these countries must adopt floating rate regimes. The move towards any of the poles by countries, however, depends upon their economic structures and inflation track record. Countries with monetary instability are more likely to move towards hard pegs.

This bipolar view has been challenged by many in literature. Rogoff et al. (2003) suggest that this bipolar view of exchange rates is neither an accurate description of the past nor a likely scenario for the next decade. Some other writers have rejected this hollowing middle hypothesis on the basis of a difference between *de jure* and *de facto* classification of exchange rate regimes. Musa et al. (2000) suggest that no single exchange rate regime can be prescribed for all countries. Nevertheless, with the increasing integration of the capital markets, there may remain a tendency towards a floating exchange rate regime. Rogoff et al. (2003) also find that advantages of exchange rate flexibility increase as a country

[1] In his paper, Pakistan has been characterized as one of the emerging markets based on the list of Morgan Stanley Capital International emerging markets.

becomes more integrated into global capital markets and develops a sound financial system.

In the case of Pakistan, since the floatation of Pak Rupee in July 2000 exchange rate management has been done fairly well. This became possible indeed with the help of the robust reserves accumulation and SBP's timely interventions in the market. I would like to highlight here, however, one visible difference in exchange rate management between the pre- and the post-September 11 periods. Before September 11, the exchange rate management was done using both market interventions and monetary policy tools, but the use of the latter dominated the use of the former. Just remember the frequent changes in discount rate and the t-bill rates during October 2000. In the post-September 11 period, however, it was mostly the market interventions, which were used to stabilize the exchange rate.

Though the exchange rate management has proved quite successful so far, we should not be complacent about the use of market interventions as a tool for the following reasons: (i) It seems that we have plenty of reserves to cushion any market need for exchange rate stability but a situation of a sharp decline of reserves, though not necessarily up to the zero level, can potentially aggravate it to a crisis situation. We don't explicitly know the psychological level of reserves and might not even be able to know, in advance; (ii) With an extended period of a stable rate at some level, the market players also become complacent about it and may take excessive risks in their foreign exchange exposures. They may think that the SBP would always be there to provide the required foreign exchange in the market to defend the rate; (iii) In a situation when we have exhausted our reserves and we may need to defend the exchange rate through interest rates, wide fluctuations in interest rates might not be well received by the market and with the growing exposure of banks in consumer financing with floating rate an increased risk of default by borrowers would put the banks in a difficult situation.

This is, however, not to suggest that we should abandon this intermediate exchange rate regime in favor of a complete float abruptly. In this regard it is suggested that: (i) We may continue to stabilize the exchange rate through market interventions, but we should stop parenting the market and let it develop at its own. The market must not be able to predict market interventions and we should let the exchange rate fluctuate more according to the fundamentals. The SBP must only enter the market when there is a dire need of it and the use of other tools have exhausted; (ii) We should use interest rates to support the exchange rate to attune the market to situations of wide spread fluctuations in the interest rates.

Now turning to 'inflation targeting' as a nominal anchor, I think IZ has made it quite clear that the fear that Pakistan is not yet ready for inflation targeting is uncalled for given the preconditions required for the adoption of IT regime and the more recent developments in the country. Here, however, I would like to add that though it is true that effectiveness of monetary policy in hitting the right inflation target is not clear but we need not be concerned if we are targeting a 'range' and not a 'point' as has been indicated by IZ while suggesting an 'IT Lite' for Pakistan. Nevertheless, while setting the 'range' utmost care must be taken so that the stakeholders take it as a 'reasonable' range since this helps in establishing the central bank's credibility when the target is met.

In the case of Pakistan, as IZ suggests for a 'large' enough target range to leave space for maneuvering to meet other targets, I think there would be a temptation for policy-makers to set an 'extra' large range. Also a distinction between 'core' and 'headline' inflation is beneficial if this is to make clear for what the central bank is responsible for. Most of the present ITers, however, target headline inflation and there are probably three to four countries (Korea, Thailand, Finland and Canada) that are targeting core inflation.

Summing up my comments, I would like to say that IZ assessment of continuing with the current intermediate exchange rate regime is very valid, but we should keep moving towards more flexibility. It is now high time to give serious thought about inflation targeting and at least we should come up with a future plan on how we are going to adopt this framework and in what time.

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